Item 6

PART 3

THE POWER OF CONGRESS TO TAX COOPERATIVES ON NET MARGINS

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I. Congress May Constitutionally Tax Cooperatives As Corporations

The fact that cooperatives are corporations and that Congress has the constitutional power to tax them as corporations may appear so obvious that discussion of the proposition is unnecessary. However, general statements have been made to the effect that the cooperatives are only agents, partnerships, or trusts, with the implication that they are not entities in their own right capable of having income subject to tax. For this reason it is necessary to establish beyond question the fact that the cooperatives are separate corporate entities which are taxable as such.

The most obvious proof that the cooperatives are corporate entities is the fact that in most cases they are organized under corporate charters granted to them by the various States. In some cases they are organized under the States' regular incorporation statutes. In many States there are special statutes for the incorporation of cooperatives. Whether or not the cooperatives are officially incorporated under State law they are treated as corporations for Federal tax purposes, since the definition of a corporation in section 3797 (a) (3) of the Internal Revenue Code includes an association.

So far as is known there has been no instance in the history of Federal taxation since the enactment of the corporation excise tax in 1909 where a cooperative association, other than one which has been specifically exempted from tax, has contended that it should not file tax returns as a corporation. In 1946, for example, the Bureau of Internal Revenue computed that 6,000 exempt farm cooperatives filed information returns on Form 990 and that 2,344 taxable farm cooperatives filed corporate income tax returns on Form 1120. It should also be noted that Congress for many years has considered cooperatives as corporations, since, in exempting certain farm cooperatives from tax, it has exempted them from the corporate tax.

In the light of the fact that the cooperatives are organized as corporations and meet the definition of corporations for Federal tax purposes, decisions by some State courts in which cooperatives have been called agents, partnerships, or trustees, or have been said to be analogous to agents, partnerships, or trustees, are immaterial in an analysis of the Federal taxing power. The courts have held repeatedly that the Federal taxing power is not restricted by definition or status determined under State law. This principle was stated definitely by the Supreme Court in the case of *Burk-Waggoner Oil Association* v. *Hopkins* (269 U. S. 110 (1925)), where it held that Congress had the right to tax as a corporation a "Massachusetts trust" which was technically a partnership under State law. At that time the Court said:

It is true that Congress cannot convert into a corporation an organization which by the law of its State is deemed a partnership. But nothing in the Constitution precludes Congress from taxing as a corporation an association which, although unincorporated, transacts its business as if it were incorporated. The power of Congress so to tax associations is not affected by the fact that, under the law of a particular State, the association cannot hold title to property, or that its shareholders are individually liable for the association's debts, or that it is not recognized as a legal entity. Neither the conception of unincorporated associations prevailing under the local law, nor the relation under the law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise should be taxed.

This same principle has been followed by the Supreme Court in *Commissioner* v. *Tower* (327 U. S. 280 (1946)), *Commissioner* v. *Lusthaus* (327 U. S. 293 (1946)), and *Commissioner* v. *Harmon* (323 U. S. 44 (1944)).

It is also well established that a corporation cannot avoid tax by arguing that it is not an entity for tax purposes but is merely an agent of its owners (*Moline Properties* v. *Commissioner*, 319 U. S. 436 (1943), and *National Carbide Corporation* v. *Commissioner*, 336 U. S. 422 (1949)). In the Moline Properties case the Supreme Court said:

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the State of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

II. The Net Margins of the Cooperatives Are Income to Them Within the Meaning of the Sixteenth Amendment and May Constitutionally Be Taxed as Such

A. THE FEDERAL TAXING POWER IS SUFFICIENTLY BROAD TO TAX COOPERATIVES' NET MARGINS

Perhaps the most concise definition of the Federal taxing power was laid down by the Supreme Court in *Steward Machine Company* v. *Davis* (301 U. S. 548 (1937)), in which the Court said:

The subject matter of taxation open to the power of the Congress is as comprehensive as that open to the power of the States, though the method of apportionment may at times be different. "The Congress shall have power to lay and collect taxes, duties, imposts, and excises" (art. 1, sec. 8). If the tax is a direct one, it shall be apportioned according to the census or enumeration. If it is a duty, impost, or excise, it shall be uniform throughout the United States. Together, these classes include every form of tax appropriate to sovereignty.

The power of Congress to tax income of all types without apportionment is derived from the sixteenth amendment:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The definition of income has been broad. The leading case defining income under the sixteenth amendment is the case of *Eisner* v. *Macomber* (252 U. S. 189 (1920)). In this case the Supreme Court said:

The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term "income"

as used in common speech, in order to determine its meaning in the amendment * * *.

After examining dictionaries in common use * * * we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 * * *. "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets * * *.

Congress has an equally broad power to determine, on practical grounds, to whom income should be taxed. This is illustrated by *Burnet* v. *Wells* (289 U. S. 670 (1933)) in which the Supreme Court held that Congress was within its constitutional power in subjecting the grantor of an irrevocable trust to tax on the income of the trust which the trustee used (pursuant to the directions of the trust instrument) for payment of insurance premiums on the life of the grantor. The Court's opinion in this case stated:

* * * Government in casting about for proper subjects of taxation is not confined by the traditional classification of interests or estates. It may tax not only ownership but any right or privilege that is a constituent of ownership. * * * Liability may rest upon the enjoyment by the taxpayer of privileges and benefits so substantial and important as to make it reasonable and just to deal with him as if he were the owner, and to tax him on that basis. A margin must be allowed for the play of legislative judgment.

The only case in which the Supreme Court has passed on a Federal statute which taxes the net margins of a cooperative is the case of *Penn Mutual Life Insurance Company* v. *Lederer* (252 U. S. 523 (1920)). In this case the cooperative organization was a mutual life-insurance company which paid dividends to its policyholders both by applying the dividends against premium receipts due from the policyholders and by actual payment in cash. The mutual insurance company argued that its gross income should have been reduced, under the Revenue Act of 1913, by the amount of the dividends to policyholders which were paid in cash and not used by the policyholders in the payment of premiums. The Supreme Court, in an opinion by Justice Brandeis, held that, while the act permitted a reduction of gross receipts by the amount of any dividends applied by policyholders against premiums, it did not permit deduction of dividends paid in cash and not used in payment of premiums.

The Penn Mutual case deals with a situation where dividends to policyholders represented a mixture of two elements: (1) profit on the investment by the company of the insurance premiums placed with it, and (2) savings on the expense of insurance protection to the policyholders. Congress had chosen to define the latter element (the rebate element) as being limited to the dividends applied by policyholders to reduce their current premiums, and Congress had chosen to treat dividends paid in cash and not so applied as a part of the income element of the mutual company. The Supreme Court said that Congress made this distinction, not because it resulted in a technically perfect measure of the two elements, but simply because the difference between the two types of dividends to policyholders "may well have seemed to Congress sufficient to justify the application of different rules of taxation." The Court said that where the net cost of life insurance proves to be less than the premiums paid, "the difference may be regarded either as profit on the investment or as a saving in the expense of protection." This shows that Congress may use any reasonable standard in measuring the taxable income of

a cooperative, and the mere fact that the corporation is a cooperative does not impose a constitutional restraint on Congress in the measurement of its taxable income. This was true in the Penn Mutual case even though the dividends in question were paid out in cash.

A mutual life-insurance company like the Penn Mutual Co. operates on the same basic principles as an ordinary marketing cooperative. In the case of the marketing cooperative, the patron turns his goods over to the cooperative for processing and resale. He receives the price of the goods he sells to the cooperative plus a patronage dividend which represents the profit margin on the processing of these goods by the cooperative. The policyholder in the mutual insurance company turns over to the company his insurance premiums and eventually these premiums are returned in the form of the face amount of the policy. Meanwhile the policyholder receives dividends which represent a return on the investment the mutual insurance company has made on the premiums the policyholder paid in. The cooperative is under an obligation to pay its net profit margins from the processing of the goods to the patron and the mutual insurance company is under an obligation to pay to its policyholder the return on its investment of his premiums to the extent that this return exceeds the reserve requirements necessary to afford the policyholder insurance protection. The constitutional right of Congress to tax a mutual insurance company on its income before payment of such dividends to policyholders as unquestioned in the Penn Mutual case. In that case, the Court said:

> The fact that the investment resulting in accumulation or dividend is made by a cooperative as distinguished from a capitalistic concern does not prevent the amount thereof being properly deemed a profit on the investment. Nor does the fact that the profit was earned by a cooperative concern afford basis for the argument that Congress did not intend to tax the profit. Congress exempted certain cooperative enterprises from all income taxation, among others, mutual savings banks; but, with the exception of fraternal beneficiary societies, it imposed in express terms such taxation upon "every insurance company."

In *Morrissey* v. *Commissioner* (296 U. S. 344 (1935)), the Supreme Court held that a trust, bearing a fiduciary relationship to its beneficiaries, may be taxed as a corporation if it is created as a medium for carrying on a business enterprise. It has also been held that a research organization established by casualty insurance companies, even though organized for nonprofit purposes, might be subjected to the corporate income tax if it could not meet the statutory requirements for exemption (*Underwriter's Laboratories* v. *Commissioner*, 135 F. (2d) 371 (1943)).

B. THE COOPERATIVES' NET MARGINS ARE INCOME TO THEM REGARDLESS OF PATRONAGE DIVIDEND CONTRACTS

As was pointed out above, a cooperative is a separate legal entity and taxable as a corporation. It is of course possible for a cooperative to act for others as an agent. However, in the typical case of a cooperative dealing with its members, it is not acting merely as their agent. As the Supreme Court indicated recently in the case of *National Carbide Corporation* v. *Commissioner* (336 U. S. 422 (1949)), some of the relevant considerations in determining whether a true agency exists are—

> whether the corporation operates in the name and for the account of the principal by its actions, transmits money received to the principal, and whether receipt of

income is attributable to the services of employees of the principal and to assets belonging to the principal * * *.

These considerations appear largely absent in the typical cooperative case. The employees of a cooperative are its employees and not the employees of the alleged principals, the members. Thus in *Lake Region Packing Association* v. *United States* (146 F. (2d) 157 (1944)), it was held that the cooperative was liable for unemployment compensation and social-security taxes. The Court specifically rejected the contention that the cooperative was merely the agent of the members and that the employees were thus in effect the employees of the members:

* * * After all, the stockholders of corporations, whether cooperative or ordinary, intend to, and do, derive advantages from the use by them of the corporate form. It is for Congress, and not for us, to say whether there should be an exemption extended to the one class of corporations and denied to the other. We think it clear that appellant stands exactly in the same case as if it were a corporation organized in the usual way for the distribution of profits to its members.

The legal title to property of the cooperative is ordinarily vested in the cooperative (*Maryland and Virginia Milk Producers' Association* v. *District of Columbia,* 119 F. (2d) 787 (1941)). As the court there indicated—

Even when a cooperative's contracts with its milk-producing members have been phrased clearly in terms of agency, it has been conceded that title to the milk passed to the association * * *.

Moreover, the cooperative sells for its own account and not for the account of the member. The circuit court in the Maryland and Virginia Milk case, above, stated further—

* * * the association, and not the member, was the actual seller of the milk which the distributors bought.

Also, the member does not set the price for which his particular products must be sold, and the sums returned to him are not attributable to profits on sales of his products but to profits on sales on all members' products (*Maryland and Virginia Milk Producers' Association,* supra).

It should also be noted that ordinarily, whether the cooperative is incorporated under the business corporation laws or under a special cooperative provision, the liability of a member for debts of the cooperative is limited, irrespective of whether the cooperative is a stock, nonstock, or membership organization (Packel, the Law of Cooperatives (2d ed.) p. 203).

The incidents of agency which the Supreme Court in the National Carbide case, supra, indicated as controlling thus appear to be entirely absent in the typical cooperative case. Moreover, it seems clear that legal title to the income of a cooperative is not in the members but in the cooperative. In the Maryland and Virginia Milk case noted above, undistributed profits of the year were carried into a revolving fund. The court held that "the fund is the corporation's property, and the member's interest in it is much like the stockholder's interest in the surplus of a stock corporation." At the most, there seems to be an obligation on the part of the cooperative to return to its members some part of the amounts which have been earned by it.

There has been little doubt that where income has been earned by one entity, such income can be taxed to it even though such entity is wholly owned by another (*Moline Properties* v. *Commissioner,* supra).

This proposition is equally true even though there is a binding obligation to pay over such income to another. The Supreme Court in the National Carbide case noted above, held that the mere fact that subsidiaries were required by agreement to pay over all profits in excess of 6 percent of capital did not prevent the imposition of income tax on such profits. A similar result was reached in *Fontana Power Company* v. *Commissioner* (127 F. (2d) 193 (C. C. A. 9, 1942)) where all the net profits of a corporation, paid over to its stockholders, pursuant to a contract, were held to be taxable to it. Finally, it is well established that where income is earned by one entity, an anticipatory assignment of such income, even though such assignment vests title to the income in the assignee, is not sufficient to prevent taxation of such income to the person who earns it (*Lucas* v. *Earl*, 281 U. S. 111 (1930); *Helvering* v. *Horst*, 311 U. S. 112 (1940)). In the Earl case, which dealt with assignment of earned salary income, the Supreme Court said:

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipating arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.

That a cooperative itself earns income seems difficult to dispute. It has assets and employees, it buys, sells, and performs services. The Supreme Court has recognized that profits derived from activities of this type are the profits of the organization owning the assets, employing the workers, and carrying out the commercial activities, even though another person has a legally enforceable claim to these profits. In the case of *National Carbide Corporation* v. *Commissioner* (336 U. S. 422 (1949)), the Supreme Court held that the corporation was taxable on its profits in spite of its contract to pay to its parent corporation all profits in excess of 6 percent on a nominal amount of capital stock. The recognition by the Supreme Court of the economic realities in such a situation is illustrated by the following quotation from the opinion in the National Carbide case:

> The same fallacy is apparent in the contention that petitioners are agents of Airco. They claim that they should be taxable on net income aggregating only $1,350, despite the fact that during the tax year (1938) they owned assets worth nearly $20,000,000, had net sales of approximately $22,000,000, and earned nearly 4½ million dollars net. Their employees number in the thousands.

Moreover, dividends paid by a cooperative on its capital stock, and amounts placed by it in reserves, stem from earnings resulting from its activities and are taxed at the present time to the cooperative as its income. This could not be the case if the cooperatives were in fact mere agents and earned no income.

There are a number of court decisions which show that taxable income is not necessarily affected by the payment of patronage dividends. In the Penn Mutual case, described earlier, Congress was upheld in its decision to treat certain cash dividends paid by mutual insurance companies to their policyholders as being taxable in the hands of the mutual corporation. In *Cleveland Shopping News* v. *Routzahn* (89 F. (2d) 902 (1937)), the circuit court of appeals for the sixth circuit held a corporation taxable on amounts collected from its patron-stockholders in connection with the furnishing of advertising services, which amounts were distributed to those same patrons in proportion to patronage. The same result was reached by the Tax

Court in *Druggist Supply Corporation* v. *Commissioner* (8 T. C. 1343 (1947)).

The Circuit Court of Appeals for the Ninth Circuit strongly indicated that patronage dividends may not be deductible even under the present law. In that case a cooperative attempted to deduct amounts set aside as reserve funds on the grounds that its earnings belonged to its members. The court denied this deduction, saying:

> * * * petitioner points to no statute authorizing any deduction whatever; and we are in effect asked to hold that a practice of respondent permitting a deduction not authorized by statute, is not liberal enough. We know of no manner in which such liberality may be reviewed in this court * * *. Whether respondent should have allowed the deduction he did allow is a question upon which we express no opinion (*Cooperative Oil Association* v. *Commissioner*, 115 F. (2d) 666 (1940)).

It is important to note that the mere fact that earnings are distributed to shareholders in proportion to their patronage instead of in proportion to stockholdings does not indicate that the distributions are not distributions of income (*Juneau Dairies, Inc.* v. *Commissioner*, 44 B. T. A. 759 (1941)). Distributions to stockholders may be dividends even though they are not proportionate to stock holdings and are not participated in by all stockholders, and even though the formalities of a dividend declaration are lacking (*Regensburg* v. *Commissioner*, 144 F. (2d) 41 (C. C. A. 2, 1944), cert. den. 323 U. S. 783 (1945)).

Congress is not bound by the Constitution to accept, at face value, the terms of a patronage dividend agreement between a cooperative and its members. The parties to such an agreement are not dealing at arm's length (as is the case in an ordinary price rebate). Under these conditions it cannot be stated as a constitutional limitation, that distributions by the cooperative to its shareholders as patronage dividends cannot be, in fact, distributions of profits. The courts have recognized the peculiar nature of transactions between corporations and their shareholders and the fact that their identity of interests may give rise to adjustments which obscure the true income of the corporation. For this reason a bargain purchase (i. e. for less than value) by a stockholder from his corporation is treated as a dividend (*Eastern Carbon Black Co.* v. *Brast*, 104 F. (2d) 460 (C. C. A. 4, 1939)).

The entire argument that the net margins of cooperatives are not income because they are paid or allocated as patronage dividends is based on the implicit assumption that the actual net margin on each article sold to a patron or purchased from a patron for marketing is exactly proportionate to the aggregate net margins on all articles bought and sold by the cooperative during the year. To the extent that this assumption is not correct excessive patronage dividends are paid with respect to some articles and only partial patronage dividends are paid with respect to other articles. For example, if a purchasing cooperative sells an article to a patron for cost and the patron also receives a patronage dividend with respect to this article at the close of the year, this dividend cannot be considered a rebate of a net margin retained by the cooperative with respect to the patron's earlier purchase of the article. The assumption of equal net margins on all articles handled by the cooperative is in direct conflict with ordinary business experience, and it is not believed that Congress is bound, under the Constitution, to accept this contrary-to-fact assumption.

III. Congress May Constitutionally Levy an Excise Tax on Corporations Measured by Their Net Margins Returned by Them to Shareholders and Others Patrons

Before the enactment of the sixteenth amendment, at a time when it was unconstitutional to tax income from property without apportionment, corporations were subjected to an excise tax measured by their net income. This tax was the corporation excise tax of 1909 (36 Stat. 112) which made corporations "subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, equivalent to one per centum upon the entire net income over and above $5,000 received by it * * *." It was argued that this tax was unconstitutional since a tax levied directly upon income had been held unconstitutional in *Pollock* v. *Farmers' Loan & Trust Company* (157 U. S. 429 (1895)). However, the Supreme Court held the corporation excise tax to be constitutional in *Flint* v. *Stone Tracy Company* (220 U. S. 107 (1911)). There the Court stated that argument on the authority of the Pollock case "confuses the measure of the tax upon the privilege with direct taxation of the state or thing taxed." The Court held this excise tax constitutional even though it was measured by the net income of the corporations from all sources, including income from tax-exempt securities.

A number of States now levy franchise taxes on corporations where the measure of the tax is the corporation's net income. These taxes have also been held constitutional by the Supreme Court even though the net income by which the tax is measured includes income from tax-exempt securities (*Pacific Company* v. *Johnson*, 285 U. S. 480).

It is clear from the Flint case and from the experience of the States with corporate franchise taxes that it would be constitutional for Congress to repeal the present corporate income tax and replace it with an excise tax on the privilege of doing business as a corporation. Such a tax could be measured by the net margins of the corporation, regardless of whether or not these margins represented income. This would be constitutional under the broad powers of Congress to select objects for excise taxation. In *Flint* v. *Stone Tracy Company* the Supreme Court stated:

> In levying excise taxes the most ample authority has been recognized from the beginning to select some and omit other possible subjects of taxation, to select one calling and omit another, to tax one class of property and to forbear another.

The cooperatives could not avoid such a tax by claiming that their net margins belong to their shareholders and other patrons. This argument was rejected by the Circuit Court of Appeals for the District of Columbia in the Maryland and Virginia Milk Producers Association case, noted earlier, where a farm marketing cooperative attempted to avoid the District of Columbia corporation franchise tax (which was measured by gross receipts) by claiming that its gross receipts did not belong to it.

It would be constitutional for Congress to supplement the present corporate income tax with an excise tax measured by the net margins of corporations (including cooperatives) which are not now taxable as income. Such a tax would be based on a reasonable classification

because it would be reasonable for Congress to require cooperative corporations to pay a tax in return for the privilege of doing business and in return for the protection and services of the United States Government which they enjoy. Since these net margins are the measure of the income tax in the case of ordinary corporations and are not now subject to income tax in the case of the cooperatives because they are paid or allocated to patrons, it would be constitutional for Congress to require from the cooperatives a tax, in the form of an excise tax, which would be equivalent to the income tax paid by ordinary corporations. Certainly a tax based on this reasoning would not be so palpably arbitrary and unreasonable as to violate the due process clause of the fifth amendment.

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